DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 06-0390
Gross Retail Tax
For 2003, 2004, and 2005

NOTICE: Under IC § 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

I. **Water Heater Rental** – Gross Retail Tax.

Authority: IC § 6-2.5-2-1; *Tri-States Double Cola Bottling Co. v. Department of State Revenue*, 706 N.E.2d 282 (Ind. Tax. Ct. 1999); 45 IAC 2.2-4-27(c); Sales Tax Information Bulletin 60 (July 2006); Commissioner's Directive 22 (January 2004).

Taxpayer challenges the Department of Revenue's decision that money it received from the rental of water heaters to Indiana customers is subject to Indiana Gross Retail Tax.

II. **Prospective Treatment of Taxpayer's Cumulative Gross Retail Tax Liability**.

Authority: IC § 6-8.1-3-3; IC § 6-8.1-3-3(b).

When and if the Department of Revenue decides that the rental of its water heaters is subject to the Gross Retail Tax, taxpayer maintains that it is entitled to prospective treatment of that determination.

III. **Ten-Percent Negligence Penalty**.

Authority: IC § 6-8.1-5-1(b); IC § 6-8.1-10-2.1(a)(3); IC § 6-8.1-10-2.1(a)(4); IC § 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer seeks abatement of the ten-percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is a registered Indiana retail merchant in the business of renting water heaters to Indiana individuals and businesses. Taxpayer contracts with its customers to provide a water heater, install the unit, and provide necessary maintenance. In return, the customers make monthly payments to taxpayer.

The Department of Revenue (Department) conducted an audit review of 2003, 2004, and 2005 records and concluded that taxpayer should have been collecting sales tax on the income

received from the rental of the water heaters. Taxpayer disagreed, submitted a protest, an administrative hearing was conducted, and this Letter of Findings results.

I. Water Heater Rental – Gross Retail Tax.

DISCUSSION

Taxpayer argues that the water heaters are "real property" and the rental income received is not subject to sales tax.

Indiana imposes a gross retail (sales) tax on retail transactions in Indiana. IC § 6-2.5-2-1. 45 IAC 2.2-4-27(c) states that, "In general, the gross receipts from renting or leasing *tangible personal property* are subject to tax." (*Emphasis added*).

However, taxpayer states that the water heaters are not "tangible personal property" but "real property." In support, taxpayer points to Sales Tax Information Bulletin 60 (July 2006) which states that, "The general rule for the application of sales and use tax is that all sales of tangible personal property and sales of real property are not." The Bulletin defines "Construction materials" as "tangible personal property intended for incorporation in or improvement to real property" and cites as a specific example "water heaters."

As additional support, taxpayer refers to Commissioner's Directive 22 (January 2004) which states that, "Example of non-taxable installations that constitute improvements to realty are . . . water heaters . . . ." (*Superseded by* Commissioner's Directive 23 (April 2004).

Taxpayer concludes in part that the "service agreements entered by [taxpayer] and its customers clearly indicate that the service agreements are lump sum contracts for improvement to realty."

The agreement between taxpayer and its customers is designated as a "Water Heater Lifetime Warranty Plan." In that agreement, taxpayer agrees to provide a new or reconditioned water heater at the customer's location for a one-year initial term and on a month-to-month basis thereafter. The taxpayer provides the water heater at "no charge" and bears the expense involved in installing the unit. The agreement cautions each customer that, "You have no option to purchase the Appliance at any time." Although the taxpayer promises to repair or replace the water heater unit, the customer is responsible for maintaining the water heater and returning it "subject to only ordinary wear and tear."

The Department is unable to agree that taxpayer's provision of water heaters constitutes an "improvement to realty." Although the water heaters require direct plumbing and electrical service, neither taxpayer nor its customers expect that the water heater will constitute a permanent addition to the customer's home or business. The parties' agreement itself is for a one-year period with the possibility of month-to-month extensions of that agreement. Both parties anticipate that if the agreement is breached, taxpayer retains the right to recover the water heater. Neither party anticipates that the customer will obtain ownership of the water heater under the terms of the agreement. ("[Customer has] no option to purchase the Appliance at any time.")

In *Tri-States Double Cola Bottling Co. v. Department of State Revenue* (Ind. Tax. Ct. 1999), the court interpreted a lease transaction as "a transfer of a right to possession of goods for consideration." Id. at 285. Taxpayer's agreement with its customers constitutes an arrangement by which the customer obtains the right – however qualified that right may be – to "possess" a water heater. Under the terms of the agreement, the water heaters are treated as tangible personal property because the agreement does not contemplate that the appliances will ever become permanent affixed or incorporated into the customers' real property. In return, taxpayer's customers promise to pay periodic "consideration" for the right to make use of the water heater. Other than the fact that installation of a water heater is somewhat more complicated, the transaction is little different than the installation and rental of a washing machine, clothes dryer, or kitchen stove.

The taxpayer is in the business of renting water heaters for consideration. The water heaters are not incorporated into the customer's real property. The money received from those rental arrangements is subject to sales tax.

FINDING

Taxpayer's protest is respectfully denied.

II. Prospective Treatment of Taxpayer's Cumulative Gross Retail Tax Liability.

Alternative to its primary arguments, taxpayer argues that it is entitled to prospective treatment of the Department's determination that the income received from the rental of water heaters is subject to sales tax.

Under IC 6-8.1-3-3, the Department of Revenue is without authority to reinterpret a taxpayer's tax liability without promulgating and publishing a regulation giving taxpayer notice of that reinterpretation. IC 6-8.1-3-3(b) states that "[n]o change in the department's interpretation of a listed tax may take effect before the date the change is (1) adopted in a rule under this section or (2) published in the Indiana Register . . . ."

Taxpayer argues that it "relied on both regulations and other published documents issued by the Department that clearly indicated that its service agreements constituted lump sum improvements to realty . . . ."

Taxpayer cites to Commissioner's Directive 22 (January 2004) and Sale Tax Information Bulletin 60 (July 2006) in support of its position that the water heaters were "improvements to realty."

The Department is unable to agree that either of the documents is dispositive of the issue. Neither document specifically discusses instances in which home appliances such as water heaters are rented to customers. A contractor can enter into an agreement to install water heaters as incorporated into the customer's real property; a vendor can enter into an agreement to rent appliances to its customers for a period of time. In the first instance, the water heater is not

subject to sales tax because the contractor pays sales tax when it first acquires the device. In the second instance, the vendor purchases the water heater without paying sales tax because it is in the business of renting appliances but collects sales tax on the stream of rental income. The taxability question does not turn on whether or not a water heater is inherently real or tangible personal property. The question is resolved by the nature of the agreement between the parties. In the first instance, the homeowner acquires a permanent acquisition to real property. In the second instance, the homeowner obtains the right to use the property by making periodic payment but never acquires ownership of that property.

The Department's assessment of sales tax does not represent a change in its interpretation of a listed tax. Taxpayer is not entitled to prospective treatment of that determination.

FINDING

Taxpayer's protest is respectfully denied.

III. Ten-Percent Negligence Penalty.

DISCUSSION

Taxpayer believes that it is entitled to abatement of the ten-percent negligence penalty.

IC § 6-8.1-10-2.1(a)(3) requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. IC § 6-8.1-10-2.1(a)(4) requires a ten-percent penalty if the taxpayer "fails to pay the full amount of tax shown on the person's return on or before the due date for the return or payment."

IC § 6-8.1-10-2.1(d) states that, "If a person subject to the penalty imposed under this section can show that the failure to . . . pay the full amount of tax shown on the person's return . . . or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall wave the penalty."

Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC § 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

Under IC § 6-8.1-5-1(b), "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." An assessment – including the negligence penalty – is presumptively valid.

Taxpayer has stated that it paid sales tax at the time it bought the water heaters. Alternatively, taxpayer has stated that it self-assessed use tax when it installed the water heaters in Indiana locations. However, taxpayer has provided no substantive evidence to that effect and the available information does not bear out taxpayer's contention. The Department is unable to agree that the evidence provided supports the contention that, in failing to collect sales tax, taxpayer acted as "an ordinary reasonable taxpayer."

FINDING

Taxpayer's protest is respectfully denied.

DK/JR/BK – March 30, 2007.